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Backgrounder

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No Excuse for Inaction:

Inflation, Special Factors and the Case for Raising Interest Rates

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The Backgrounder in Brief

Inflation in Canada is well above the Bank of Canada's 2 percent target. Over-rapid money growth, rather than adverse movements in individual components of the consumer price index, explains this price pressure. To rein in further CPI increases and maintain confidence in its low-inflation strategy, the Bank should nudge short-term interest rates up in early March

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Since it last raised interest rates in July of 2002, the Bank of Canada has warned Canadians frequently that inflationary pressure is building, and that, ultimately, short-term interest rates must rise to rein it in. Since July, inflation has climbed and the year-over-year rate of increase in the consumer price index (CPI) moved above 3 percent in October, breaching the one-percentage-point buffer that surrounds the Bank's 2-percent inflation target.

This movement suggests that the Bank's basic diagnosis of the situation is correct. However, instead of attributing higher inflation to its own past policies, and doing something to remedy the situation, the Bank recently started attributing rising inflation to adverse movements in the prices of specific products. Some might find justification for the Bank maintaining a stand-pat monetary stance since July in this line of argument; we think it has led to a delay in further rate increases that has persisted long enough to arouse concern.

Monetary policy is always an uncertain business. In the four years after the Asian crisis and the Russian default of 1997/98, the Bank was likely right to take risks on the expansionary side. Now, we judge that the time has come for it to err on the side of caution. If current policy procrastination permits inflation to continue at its current rate of more than 3 per cent over the next year, the credibility of Canada's inflation targets themselves will be tarnished. The pain involved in establishing low inflation in Canada in the early 1990s in due course yielded some benefits in the second half of the decade when it finally became a credible feature of the economic landscape. A policy stance that risks eroding that credibility is unacceptable.

The Current Situation

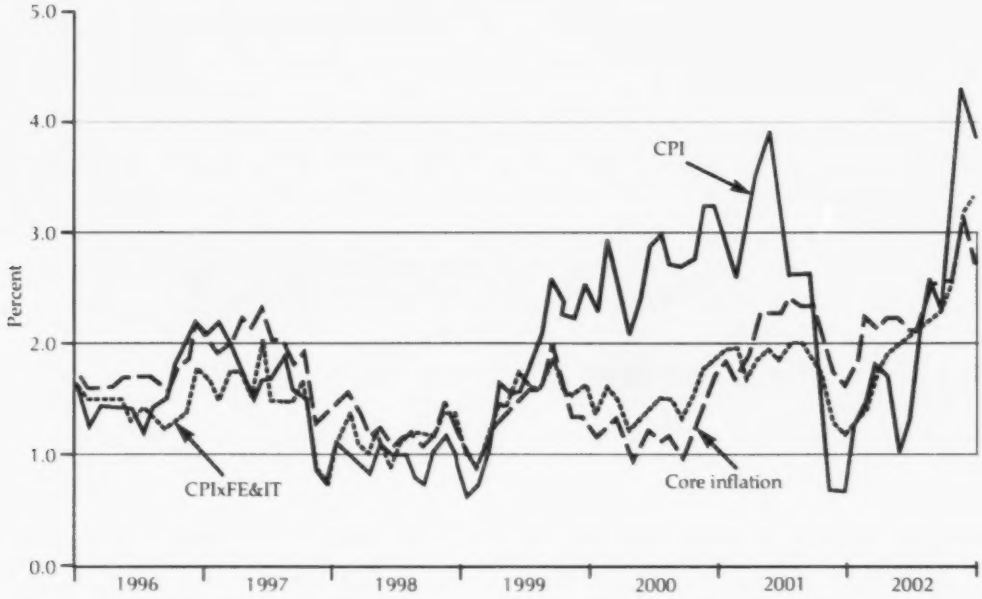
The Canadian economy did well in 2002 — better, indeed, than almost anyone expected. Real GDP appears to have risen by around 3.5 percent and net employment creation amounted to a remarkable half-million jobs. On all of these measures, as in the previous three years, Canada's performance was better than that of the United States. Even the Canadian dollar's decade-long depreciation against its US counterpart seemed to be coming to a halt as the year ended. Especially after the disappointments of the early and mid-1990s, Canadians are entitled to take satisfaction in this performance.

To be sustainable, however, economic growth requires steady expansion and improvements in both the capital stock and the labour force, not to mention sustained technological innovation. An economic upswing, supported by accommodative monetary conditions, that threatens to push demand beyond the limits imposed by available supplies and productivity will produce rising prices and, depending on how long the central bank delays action to keep inflation under control, perhaps a painful slump, too.

Rising Inflation and Money Growth

The single most important and straightforward piece of evidence that recent growth rates are not sustainable comes from inflation itself (Figure 1). The total

Figure 1: CPI Inflaton and Target Band (Year-over-Year Changes)



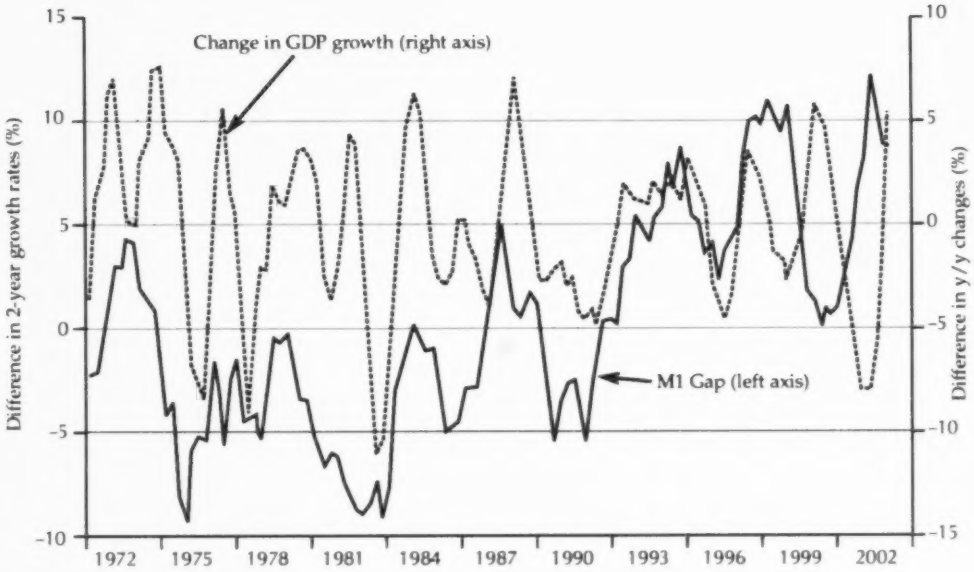
CPI, the measure to which the 2-percent target (with a 1-percentage-point error band) applies, registered year-over-year increases around 4 percent at the end of 2002. Another commonly watched measure of inflation, the CPI excluding food, energy and indirect taxes (CPIxFE&IT), which excludes some items with erratic monthly price movements that can obscure longer-term trends, rose 3.4 percent year-over-year. And a third measure, the CPI excluding its eight most volatile components and indirect taxes (the Bank's preferred measure of core inflation, formerly known as the CPIX), which also attempts to abstract from some of the noise in the overall measure, was running at 2.7 percent.[1]

The general upward trend in all these measures over the seven years illustrated in Figure 1 suggests that the macroeconomic environment and, in particular, the rate of monetary expansion promoted by the Bank of Canada, put upward pressure on inflation. Experience indicates that in Canada, depending on the state of the economy, a shift in monetary policy takes a year to 18 months to noticeably affect inflation. During the intervening period, the first impact of monetary expansion is on real output growth. The results of these two effects are combined in the behaviour of nominal output.

Figure 2 illustrates the relationship between money and nominal output growth with reference to M1 — primarily currency and chequable deposits — a measure of liquid money that reacts quickly to changes in expectations and changes in the stance of monetary policy. Specifically, it plots what in the past we have referred to as the M1 gap — the rate of growth of M1 relative to the growth of

1 The Bank of Canada introduced its new measure of core inflation in 2001. See Macklem (2001) for a discussion of the differences between the old and new indices and the Bank's reasons for making the change.

Figure 2: M1 Gap and Changes in Nominal GDP Growth



nominal GDP — against subsequent fluctuations in nominal GDP growth. Beginning slowly at first in 1999, Canada had a burst of growth in M1 that was briefly interrupted in late 2000/early 2001, but regained momentum afterwards.[2] As Figure 2 illustrates, this rise in M1 growth preceded an upsurge of spending in Canada, which occurred despite a slowdown and uncertain recovery in the United States and, in turn, makes the recent upward movements in inflation unremarkable.

This way of looking at recent events also permits some informed speculation about the future. On recent evidence, spending will continue to outpace the economy's productive capacity in the near term and inflation — whether measured by the CPI or the less volatile core indexes — will stay at or above the upper end of its target range well into 2003. What happens afterwards depends on whether the slowdown in monetary expansion that was becoming evident in monthly data in late 2002 is sustained. If it is, spending will slacken as the year progresses and inflation will eventually begin to fall. If it is not, then inflation will remain uncomfortably high. These alternatives make the Bank of Canada's stance over the next few months critical.

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2 The M1 gap data displayed in Figure 2 are measured over two-year intervals and are thus centered a year earlier than shown, as are GDP growth data. The long interval over which the gap is measured obscures a short-lived interruption in money growth that marked the turn of 2000/01, which would be more visible in year-on-year data. Figure 2 also shows that there has been an upward trend in the M1 gap since the mid-1980s. This reflects sustained structural change in Canada's financial system, which earlier C.D. Howe Institute studies have discussed (e.g., Boesenkool, Laidler and Robson 1997). The topic would merit revisiting in more detail than can be accorded it here. Nevertheless, swings in the M1 gap around this trend continue in a rough-and-ready way to lead swings in the growth rate of nominal spending and that is what matters for the argument of this *Backgrounder*.

Figure 3: Nominal and Real-Return Bond Rates

A Small Problem Might Get Bigger

Canada's target for CPI inflation has been 2 percent for seven years. As Figure 1 shows, actual inflation was generally below 2 percent until 1999. This was the result of a number of factors: over-cautious monetary policy in the earlier part of the decade and, later, the effects of the world-wide slowdown associated with the Asian crisis of 1997. An accommodative monetary stance was, therefore, appropriate in its wake and may indeed have helped Canada avoid a recession after the Russian default in late summer of 1998 that came in the immediate wake of the Asian crisis. Canada's long experience of low inflation in the 1990s likely helped contain the impact of more expansionary policy on prices for a while.

As we come closer to the present, however, these restraints were less effective. The bursting of the high-tech bubble in 2001 marked the start of a shallow recession in the United States and a slowdown in Canada, even before the events of September 11, 2001, cast further clouds over the outlook. The Bank of Canada initially lowered rates further to prevent inflation falling below 2 percent, though hindsight suggests to us that this response was somewhat overdone. An inflation rate that now seems likely to run between 3 and 4 percent in early 2003 raises the stakes for monetary policy in the coming months.

We have argued in earlier C.D. Howe Institute publications (for example, Robson and Laidler 2002) that low inflation targets did not become fully credible in Canada until the second half of the 1990s. Before the 1995 federal budget, mounting federal debt and the threat that the government might finance it by printing more money cast doubt on the Bank of Canada's ability to keep inflation under long-run control. Since 1995, however, with sound fiscal policy, inflation

expectations appear to have fallen to the 2-percent range (Figure 3 shows one useful measure of inflation expectations: the yield spread between long-maturity nominal- and real-return bonds).[3] Since then, a virtuous policy circle has developed in which low actual and expected inflation, low nominal interest rates and a benign fiscal environment interacted to produce greater macroeconomic stability (Longworth 2002) and — though this conclusion is more tentative because of the limited amount of data available — higher productivity and income growth as well.

As Figure 3 reveals, however, expectations respond to experience. While Canada's inflation targets are currently credible, they will not retain that status if they are missed too often. An inflation rate running above 3 percent is a nuisance rather than a serious problem only for as long as it is expected to fall back towards 2 percent soon and to stay in the target range afterwards. If this does not happen, an upward drift in expectations will pose an awkward choice between imposing a possibly painful disinflation or allowing the same kind of upward drift in inflation that characterized the early 1970s and the late 1980s.

The possibility of an upward drift in inflation expectations was hinted at by the Bank of Canada itself in the closing comment of its latest *Monetary Policy Report Update* (Bank of Canada 2003, p. 5), where it commented on the likely need for some policy tightening later in 2003:

It is particularly important to prevent inflationary expectations creeping up over the balance of the year.

> With the persistence of high rates of inflation, there is a risk of an increase in inflation expectations. If this were to occur, inflation pressures would be stronger and the need for policy action by the Bank would be correspondingly greater.

The Bank does not here, or anywhere else in its recent statements, entertain the option of settling for a higher rate of inflation, should it begin to become entrenched in expectations. If it does become entrenched, however, that option will attract support. This is surely a debate well worth avoiding, which is why it is particularly important to prevent inflationary expectations creeping up over the balance of this year.

The Special Factors Theory of Inflation

Our concerns on this score have been heightened by the Bank's tendency, in its commentaries on inflation through 2002, to refer to special factors affecting prices of particular goods and services as explanations of the behaviour of the overall price level. The Bank's account of its decision to leave the overnight rate unchanged on December 13, 2002, for example, began: "Core and total CPI inflation have remained above the Bank's 2-percent target for inflation control, largely as a result of one-off price movements, such as the increased insurance premiums," (Bank of Canada 2002a, p. 1). That was a line of argument the Bank

3 The geometric yield spread shown in Figure 3 has been remarkably close to 2 percent consistently since late 1999. Formal tests of whether inflation has become more stable in the face of booms and slumps are difficult at the moment, because the economy has not gone through the necessary cycles since 1995.

had developed at greater length in its October 2002 *Monetary Policy Report* (Bank of Canada 2002b, pp. 7–9, 24–25 and especially Box 1, p. 8). And in a recent speech dealing with the outlook for inflation and monetary policy, Governor David Dodge explicitly referred to insurance premiums, along with oil and gas and electricity prices in Ontario, not to mention tobacco taxes, as having contributed to the recent rise in inflation (Dodge 2003).

There may be a case for discounting short-term movements in the total CPI when these reflect particularly volatile prices that are outside the core index. In the 1990s, the Bank often discounted short-term phenomena and the core rate of inflation did, on average, provide a better indication of longer-run trends in CPI inflation than the monthly headline rate (Macklem 2001). Still, the hazards inherent in this approach became evident in the period from the spring of 1999 to the fall of 2001 when, as Figure 1 shows, CPI inflation exceeded core inflation for 30 months in succession.[4] For a while, this episode looked like an isolated event. But the lower inflation (on all measures) that followed it was short-lived, and it is now beginning to look more like a first step toward a higher long-run inflation rate.

Worse, the Bank of Canada's most recent explanations of the behaviour of the CPI have pointed not just to special factors outside the core index, as they have previously, but to some factors within the core, as well. To be fair, the Bank's most recent *Monetary Policy Report Update* (Bank of Canada 2003) does refer to overall price pressures in the economy when it comments on the persistent tendency of inflation to remain above the 2-percent target. It also, however, persistently highlights rising insurance premiums as an issue, and comments on the effects of supply shortages in specific energy and food markets as though they had arisen independently of the overall relationship between supply and demand in the Canadian economy.

Isolating particular prices and attributing movements in the total CPI to their behaviour encourages confusion.

The crux of the problem here is that isolating particular prices and then attributing movements in the total CPI to their behaviour encourages confusion between arithmetic and economics. Such reasoning can prompt the unwary to make the implicit assumption that the CPI's components are determined in isolation from one another and that what happens to the total index is simply the weighted sum of a series of independent effects. On the contrary, however, the overall behaviour of the price level, as measured by the CPI or any other broad index, is above all else a function of the pressure exerted by aggregate spending on the economy's ability to produce.

How much room sellers of any particular item have to raise prices depends on the overall inflationary environment and on pricing decisions being taken at the same time by sellers of other things, as well as on factors specific to their own market. We very much doubt, for example, that the amount by which insurance premiums rose towards the end of 2002 was independent of inflationary pressure in the economy overall. While individual pricing decisions reflect factors specific to the market for which they are taken and while for each individual decision considered in isolation these specific factors will loom large, the effects of such specific factors tend to cancel out economy-wide, leaving the overall inflationary

4 The C.D. Howe Institute complained about this event while it occurred (Laidler and Aba 2000).

environment to be influenced by aggregate supply and demand, a balance in which monetary policy plays a key role.[5]

While a core inflation measure may help policymakers see through special factors over short time periods, it should not lead them to ignore an increase in the general inflation rate which happens to be accompanied by a persistent movement in a particular relative price. Still less should the behaviour of particular relative prices within a core inflation measure tempt them to downplay the significance of an increase in the Bank's own preferred indicator of longer-term inflationary trends.

The danger for policy is that, every month, some specific prices will rise more than either the total CPI or the core index. Discounting these movements, if it becomes a habit, will push the Bank towards concluding that inflation is really lower than the price indexes suggest and that interest-rate increases are not necessary. As each month's special factors are succeeded by the next month's special factors, however, overall inflation will stay above target. The longer it remains there, the more obvious will it become that there is a choice to be made between suffering the consequences of higher interest rates to get it back to 2 percent or settling for a higher target. And the more voices that join in making the case for tolerating rising prices, the harder it will become for the Bank to bring inflation back under control.

These circumstances look like the first stages of an old-fashioned expansion, driven by monetary policy, with a predictable effect on overall inflation.

The Current Policy Choice

Extracting policy-relevant information from inflation data is not an exact science. The Bank of Canada did raise the overnight rate three times between April and July of 2002 and rates of monetary expansion have slowed somewhat since then. For all the misgivings we have just expressed about the Bank's analysis of recent inflation data, it might just be that the latest money figures signal a cooling economy and presage a return of headline inflation toward the target without further interest-rate increases in the immediate future.

The robust performance of the Canadian economy in 2002, however, along with inflation's tendency to respond to monetary policy with a lag of at least a year, makes us reluctant to gamble on this possibility. M1 grew at double-digit rates, with only one temporary interruption, for close to three years until November of 2002; output and employment surged from mid-2001 onwards; more recently, the Bank of Canada's estimate of the output gap has fallen to zero, and there was a residential real estate boom, as well.

These are not circumstances in which special factors are required to explain a pick-up in inflation. They look much more like the first stages of an old-fashioned expansion, driven by monetary policy, which is beginning to have its predictable effects on overall inflation. Governor Dodge's recent (Dodge 2003) concession that,

5 Over a period as short as a month or a quarter, special factors do not always completely cancel out, particularly when they affect a large segment of the retail market-place, as in the case of indirect tax changes, or an important component of the consumption bundle, as in the case of energy. This is why stripping the CPI of such effects to produce a measure of core inflation may help forecast longer-run inflationary trends. As the time period observed lengthens, however, this advantage disappears.

the role of special factors notwithstanding, inflation has been running at rates higher than the Bank of Canada expected and that generalized demand pressures had something to do with this, is therefore welcome.

In the light of all this, we think that the Bank of Canada's warnings in its latest *Update*, repeated in a recent speech by the Governor, that further monetary tightening in 2003 may be required to relieve inflationary pressure in Canada are apt. We would urge that, whether in its communications with the public or in its internal debates, the Bank should stop trying to explain away as special events awkward price increases that appear to raise the headline rate of inflation. Total CPI inflation is what matters for the purchasing power of money in the hands of Canadians, total CPI inflation is what the Bank is supposed to target and total CPI inflation is currently too high. It is time that the Bank of Canada gave its undivided attention to these central issues.

Since the mid-1990s, Canada has enjoyed its lowest inflation in a generation. With reinforcement from fiscal policy, the result has been a macroeconomic environment that supports productivity growth and long-term gains in living standards. Just as monetary policy played a key role in achieving that environment by creating and maintaining low inflation, so must monetary policy now work to preserve the credibility of the Bank's commitment to sustaining that environment. A hike in the overnight rate on March 4 would be a small risk to take in pursuit of that outcome.

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